IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX REFERENCE NO.688 OF 1987

M/s.Lipi International
16, Phatak Baug,
Pune .. Applicant.

V/s.

The Commissioner of
Income-tax, Pune .. Respondent.

Mr.S.N. Inamdar with Mr.A.K. Jasani
for the applicant.

Mr.Ashok Kotangale for the respondent.

CORAM : F.I. REBELLO &
J.P. DEVADHAR, JJ.

DATED : 1ST AUGUST, 2007.

ORAL JUDGMENT : (Per F.I. Rebello, J.)

1. A reference has been made to this Court at the instance of the applicant M/s.Lipi International. The questions of law which have been referred are as under :

> "1) Whether, on the facts and in the circumstances of the case and on a proper construction of the Agreement of sale dated 22.12.1977 the Appellate Tribunal was right in law in holding that the lumpsum of Rs.5 lakhs was a revenue receipt.
>
> 2) Whether on the facts and in the circumstances of the case the Appellate Tribunal was right in law in holding that since in the hands of the payer the payment was held as not resulting into acquisition of any capital asset or advantage of any enduring nature, the receipt in the hands of the payee has necessarily to be treated as revenue receipt ?"

2. A few facts may now be set up. The applicant - assessee is a registered firm and in terms of Deed of Partnership was carrying on the following business :

(a) Designing, manufacturing and selling high pressure of burner and hearing system for boilers and furnaces ;
(b) Manufacture of pressure vessels, beat exchangers etc.
(c) Erecting of plant equipments;
(d) Carrying on such other business as may be mutually agreed upon by the partners;

. On 22-12-1977, the assessee firm entered into an agreement for sale of five different models of boilers and fuel firing equipments with different capacities based on different fuel systems identified by respective drawings, designs, layouts, specifications, technical data and write-up on manufacturing processes, more particularly described in schedule B to the agreement and forming part of the agreement. In the recital to the agreement it was set out that the assessee had decided to concentrate on its other activities to the entire exclusion and discontinuance of the manufacture of the boilers and fuel firing equipments and hence

agreed to sell the five models developed and owned by it to the applicant for a total consideration and price of Rs.5,00,000/- (Rupees Five lacs only) on the terms and conditions etc. set out therein.

. Clause 2.2 of the terms which were the essence of Contract of Sale read as under :

> "2.2 THE SAID FIRM undertakes not to engage itself in the manufacture either alone or in association with some-one else, of any of these models which have been sold by it to the SAID COMPANY or any other type of boilers".

. Another relevant clause is clause 3.4 which reads as under :

> "3.4 The SAID FIRM assures the SAID COMPANY that each of the MODELS sold by the SAID FIRM to the SAID COMPANY is the only MODEL of that capacity and of the system developed by the SAID FIRM and it has no other MODEL which is capable of competing in size and capacity or in technology with the models sold by the SAID FIRM to the SAID COMPANY under this agreement as on date".

. The transaction was completed and in lieu thereof the firm has paid total consideration of Rs.5,00,000/- (Rupees five lakhs).

3. The applicant was assessed for the assessment year 1978-79. The assessing officer came to the conclusion that the receipt is not self generated or on goodwill account since the

assessee's fundamental expertise and know-how is put to use in a commercial sense as an integral part of its business. It held that the receipt is not a capital receipt nor in nature of capital gains. The income, therefore, was taxed as a revenue receipt. The applicant aggrieved preferred an appeal. The Commissioner held that the agreement is not for designing of boilers, but is for an outright sale of the technical know-how. The applicant had relied on the judgment in the case of Commissioner of Income Tax V/s. Ralliwolf Limited reported in 143 ITR 720. The Commissioner (Appeals) accepted the contention of the applicant that the amount of Rs.5,00,000/- received was for sale of entire boiler technology and system and does not refer to the sale profits of five models of boilers as such and as such held that the said amount of Rs.5,00,000/- is a capital receipt.

4. The Revenue aggrieved preferred an appeal before Income Tax Appellate Tribunal, Pune Bench. The ITAT, after considering the contentions, various judgments and the agreements, has observed that,

> "From the plain reading of the sale agreement it is seen that there is no evidence to show that the assessee cannot take up the other activities of designing, manufacturing and selling of oil burners to the exclusion of these 5 models"

. A further finding was recorded that, "both the purchaser and seller are in the field of same business activity and the assessee and the purchaser intended to exploit this technical date for the manufacture of oil burners and fuel firing equipments" and, therefore, held that the receipt would be revenue receipt and not a capital receipt.

. As reference was sought for by the applicant, the learned Tribunal was pleased to refer it in terms of the questions as framed.

. In answering the questions that are referred, the main question that we have to answer is whether the receipt of Rs.5,00,000/- in the hands of the assessee could be taxed as a capital receipt or revenue receipt ?

5. One of the tests to decide whether the receipt partakes of a revenue receipt or capital receipt is whether the receipts from the transfer of know-how are of capital or revenue nature. That would depend on the nature of the transaction out of which the receipts arose and the context in which the receipts are received. If the imparting of know-how is really in the nature of services rendered without anything more, the receipt must be treated as a revenue receipt. However, when the

consideration is received for imparting know-how in association with the disposal of capital asset, then the receipt will have to be treated as capital receipt. In the instant case, the facts which are admitted on record are that the applicant firm and the company to which if sold the know-how were in the same business. By virtue of the agreement, the applicant firm decided to transfer five models developed by them along with technical know-how for a consideration of Rs.5,00,000/- and further undertook not to engage itself in the manufacture either alone or through someone else of any of the models which were sold by it or any other type of boilers. In other words, the partnership withdrew itself from the business of manufacture and/or designing not only of the five models sold to it but also any other type of boilers. By the agreement, the boilers along with the know-how was sold to the companies.

6. We may now proceed to consider the judgments cited at bar to identify the tests as to when the receipt could be said to be a revenue receipt and when it would be a capital receipt. In Commissioner of Income Tax, Bombay City - 1 V/s. Automobile Products of India reported in 140 ITR 159, the assessee was manufacturing diesel engines in collaboration with a foreign company. The assessee

was unable to make profit due to non-manufacture of trucks into which the engines could be fitted. The Government granted licence to the assessee to manufacture trucks. Due to paucity of foreign exchange, the assessee company transferred to another company its undertaking for manufacture of engines and received lumpsum amount. The assessee was not to engage in manufacture, assembling or sale of engines to be manufactured by transferee. Giving up licence for manufacture of engines affected the profit-making structure of the assessee's business. This Court held that the transaction was not a normal incident of business and that opportunity to make profits under collaboration agreement taken in conjunction with surrender of the industrial licence was a capital receipt and that amount received as compensation is a capital receipt.

7. In Commissioner of Income-tax, Bombay City-I V/s. Ralliwolf Limited reported in 143 ITR 720, there was an agreement between the Wolf company and Rallis for the assembly and partial or complete manufacture of certain tools in India under the name "Wolf" and this arrangement was to continue till a new company was promoted and commenced business. On 31-10-1958, M/s.Ralliwolf Limited was incorporated in India on the condition that Rallis would be the majority shareholders. The issued capital of

Ralliwolf was of 20,000 shares of Rs.100 each. There were various agreements between Rallis India Limited and Wolf Electric Tools (holdings) Limited. The main object of Ralliwolf was to manufacture and market in India, portable electric tools and components thereof. There were several agreements. By an agreement dated 16-02-1989, in consideration of the issue of 3,625 shares in the capital of Ralliwolf, the Wolf company was to provide and make available to Ralliwolf all present and future drawings, designs, schedules and technical knowledge and data necessary for the establishment, erection and installation of the factory and the production of selected tools. The agreement was to remain in force as long as the manufacturing and marketing agreement to be executed was put in force which was executed on 19-08-1959. Under this agreement, it was agreed that the tools manufactured or assembled in India were to be sold only in India and Nepal. Remaining 5,325 shares were subscribed by the Wolf Company in consideration of the transfer of certain plant and equipment to enable the Indian factory to commence work. In the assessment year 1960-61, considering the value of the shares issued, the Income Tax Officer held that the value of 3,625 shares was of income nature and accordingly it was charged. In appeal, it was held that income could not be deemed to be accrued or arise during the

relevant accounting year in India. In appeal to the Tribunal, the transaction was held to be of wholly capital nature and the value of shares was treated as capital receipt. One of the factors considered was that the shares received by Wolf company from Rallis had come up in the assessment proceedings of the assessee company, London. Chandurkar, J. answering the reference held that it was wholly of a capital nature. Various judgments were cited as to when the receipt could be said as a receipt on revenue account or capital account. The learned Bench referred to the test laid down by Bankes L.J., in British Dyestuffs Corporation (Blackley) Ltd V/s. IRC [1924] 12 TC 586 (CA) where it was observed thus,

> "The real question is, looking at this matter, is the transaction in substance a parting by the company with part of its property for a purchase price, or is it a method of trading by which it acquires this particular sum of money as part of the profits and gains of that trade ? For that purpose one has to look at the nature and substance of the transaction and the agreement as a whole."

. The issue as to the nature of know-how as an asset was also considered. After considering various English authorities, the learned Bench of this Court was pleased to observe as under :

> "The legal position of these authorities, therefore, is that know-how is not strictly a fixed asset and the nature of receipts

> from the know-how would essentially depend upon the transactions out of which the receipts arise and the context in which the receipts are received. If the imparting of know-how is really in the nature of services rendered without anything more, the receipt must be treated as a revenue receipt. But when consideration is received for imparting know-how in association with the disposal of a capital asset, then the receipt will have to be treated as a capital receipt."

8. We may gainfully refer to the following observations in CIT V/s. Ciba of India Limited reported in [1968] 165 ITR 51 (SC) as to what is know-how. The Supreme Court observed as under :

> "Counsel for the Commissioner strongly pressed for acceptance of what he called the principle of the speeches of Viscount Simonds and Lords Tucker and Denning in Evans Medical Supplies Ltd. v. Moraarty [1957] 37 Tax Cas 540; [1959] 35 ITR 707 (HL). Counsel said that it was ruled in that case by the majority of the House that money received by a taxpayer for making available to another person a right to technical 'know-how' is liable to be treated as a capital receipt. It must in the first instance be noted that the House of Lords was dealing with the true character of a receipt by a taxpayer who had made technical 'know-how' available to another in consideration of a certain payment. <u>The nature of a receipt as capital or revenue is not always determinative of the nature of the outgoing in the hands of the person who pays it.</u> Again the view expressed by the majority of the House does not lay down any principle which may be of value in deciding this case." (emphasis supplied)

9. Our attention was invited to some of the English Judgments in the case of Rolls-Royce Limited V. Jeffrey (Inspector of Taxes) reported in [1962] I W.L.R. 425; judgment in Murray (Inspector of

Taxes) V. Imperial Chemical Industries Limited reported in [1967] Ch. 1038 and judgment in Wolf Electric Tools Limited V/s. Wilson (H.M. Inspector of Taxes) reported in 1969 (2) All E.R. 724. It is not necessary for us to consider the ratio of the said judgments as the judgment in Rolls-Royce Limited and Wolf Electric Tools Limited has been considered in the judgment of this Court in Ralliwolf Limited (Supra). However, we may reproduce the following observations of lord Denning, J. in Murray (Inspector of Taxes) (Supra):

> "-------. But it seems to me fairly clear that if, and in so far as, a man disposes of patent rights outright (for example, by an assignment of his patent, or by the grant of an exclusive licence) and receives in return royalties calculated by reference to the actual user, the royalties are clearly revenue receipts. If, and in so far as, he disposes of them for annual payments over the period, which can fairly be regarded as compensation for the user during the period, then those also are revenue receipts (such as the payment $10,000 a year in the present case). If, and in so far as, he disposes of the patent rights outright for a lump sum, which is arrived at by reference to some anticipated quantum of user, it will normally be income in the hands of the recipient (see the judgment of Lord Greene M.R. in Withers v. Nethersole; approved by Lord Simon in the House of Lords). <u>But if, and in so far as, he disposes of them outright for a lump sum which has no reference to anticipated user, it will normally be capital (such as the payment of $25,000 in the British Salmson case).</u> It is different when a man does not dispose of his patent rights, but retains them and grants a non-exclusive licence. He does not then dispose of a capital asset. He retains the asset and he uses it to bring in money for him. A lump sum may in those cases be a

> revenue receipt" see Rustproof Metal Window Co. Ltd. v. Inland Revenue Commissioner, per Lord Greene M.R., who emphasises that it was a non-exclusive licence there. Similarly a lump sum for "know-how" may be a revenue receipt. The capital asset remains with the owner. All he does is to put it to use." (emphasis supplied)

10. It is, therefore, clear that there is no single determinative test to decide the nature of the receipt, whether capital or revenue. To answer the issue, one will have to examine the terms of contract, the nature of transaction or the terms of transfer of know-how. One of the tests would be is the agreement for transfer of the asset, a method of trading by which it acquires the source of income. If yes, then normally it would partake of a revenue receipt. If on the other hand there is a complete disposal of the asset with the know-how resulting in parting of the asset for a lumpsum, with no reference to anticipated user, it would be a capital receipt.

. Considering the case, from what is set out earlier, let us examine the nature of transaction in this case. Admittedly pursuant to the agreement the boilers which were developed by the applicant along with respective drawings, designs have been transferred by the applicant for a specified amount. Not only that, the applicants have further agreed not to engage itself in manufacture either alone or

in assistance with someone else, of any of these models which have been sold as also any other type of boilers. There are further clauses which set out that the applicant has no other model of that capacity and of the system developed which is capable of competing in size and capacity or in technology with the models sold to the company. From the above clauses, in the agreement it would be clear that there has been parting of an asset along with know-how and the transferee has not retained any right in itself in the said transferred assets and on the contrary has agreed not to carry on further business in the manufacture or design of boilers.

11. In our opinion, all these clauses would clearly indicate and show that the consideration received is a capital receipt.

12. Having so held, we answer the questions as referred in the negative, in favour of the assessee and against the revenue. The reference is disposed of accordingly.

(F.I. REBELLO, J.)

(J.P. DEVADHAR, J.)